

Banking Economics

Lecture 2

Banking Intermediation

João Afonso Saraiva Coelho

Faculty of Economics, University of Coimbra, Portugal

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(Slides adapted from Fátima Sol Murta and João Ricardo C.)



FACULDADE DE ECONOMIA
UNIVERSIDADE DE
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Outline, Goals, and Main Bibliography

► Outline:

1 Banking intermediation

1.1. Definition and specificity of banking intermediation

1.2. The evolution of banking systems and the European and Portuguese banking sectors

1.3. The banking sector and the SDGs

► Goals:

Characterize the activity of banking intermediation, understand its importance and its benefits for economic agents;

Describe and relate the trends that characterize the banking sector today, particularly in Portugal and Europe.

► Main Bibliography:

Casu, B., Girardone, C., & Molyneux, P. (2006). *Introduction to Banking*. FT Prentice Hall.
(Chapters 1 and 2)

Matthews, K., & Thompson, J. (2014). *The Economics of Banking* (3rd ed.). John Wiley & Sons. (pages 1-21)

1.1. Definition and specificity of banking intermediation

- ▶ In modern economies, saving and investment decisions occur easily and smoothly, operating somewhat independently from each other due to the existence of the financial system.
- ▶ The financial system is made up of all financial intermediaries and financial markets, as well as the flows of funds established between them and households, non-financial firms, the government, and the rest of the world. It also includes financial infrastructure, i.e., the set of institutions that enables the functioning of markets and intermediaries (e.g., payment systems, collateral/guarantee registries, etc.).

1.1. Definition and specificity of banking intermediation

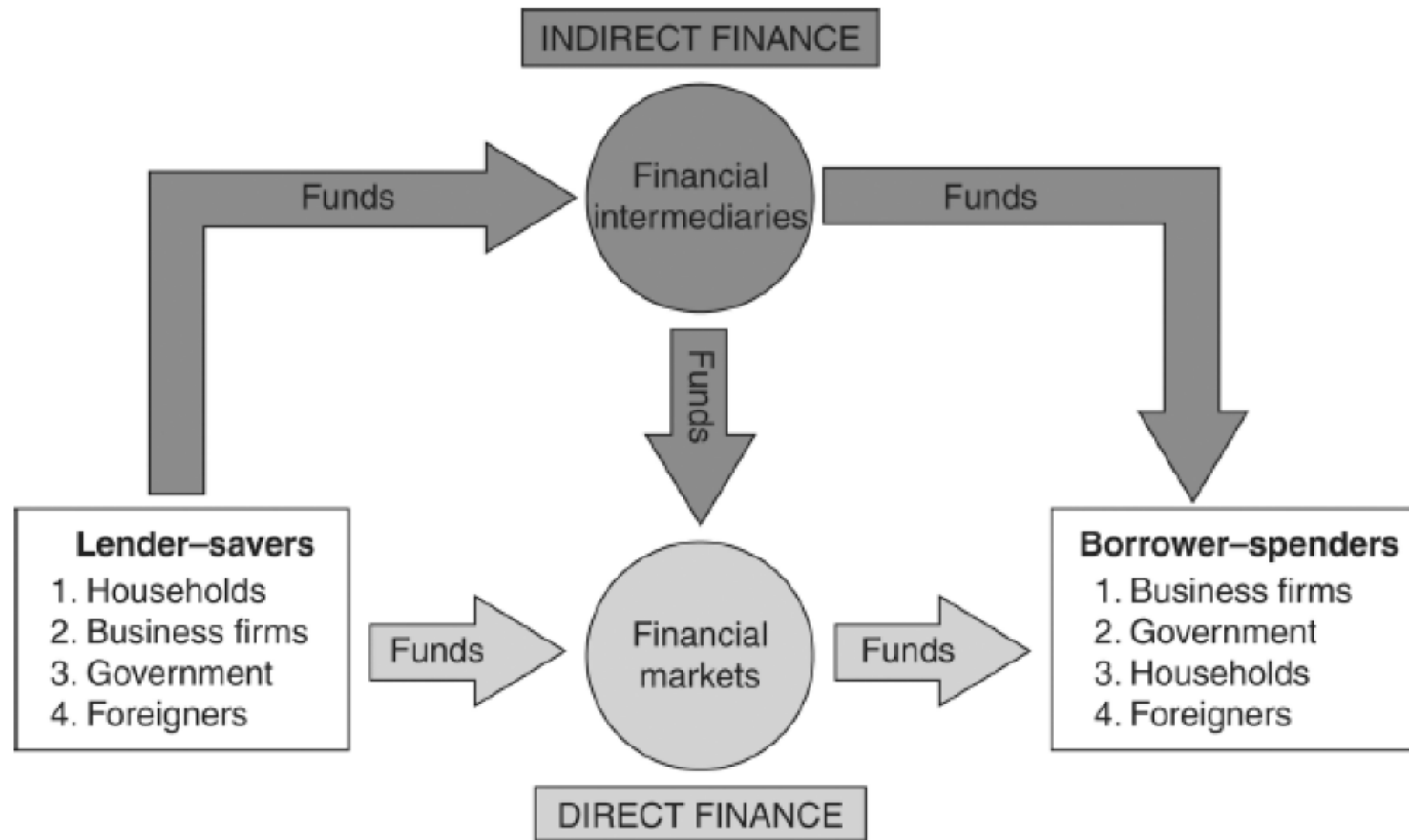


Figure 1. The financial system. Source: Mishkin (2006).

1.1. Definition and specificity of banking intermediation

- ▶ **Main task of the financial system:** to channel funds from economic agents with a **surplus** to those with a **shortage** of funds.
- ▶ Within the financial system, there are two routes for moving funds from **lenders** to **borrowers**:

Direct finance: one economic agent borrows funds from another via **financial markets** (i.e., a market in which participants issue and trade securities);

Indirect finance: a **financial intermediary** obtains funds from savers and uses these savings to issue loans to a sector in need of finance.

- ▶ However, it is important to note that many firms in advanced economies rely on **internal funding** (retained earnings) to finance their operations. Therefore, it is not always necessary for firms to obtain financing through external sources via the financial system.

1.1. Definition and specificity of banking intermediation

► Financial systems classification and categorization

Depending on the relative importance of the **two routes** of channeling funds from **savers** to **borrowers**, we can classify **financial systems** as follows:

Marked-based system: the channeling of funds occurs mainly through **financial markets**, making **direct finance** more important than indirect finance;

Bank-based system: the flow of funds within the financial system occurs mainly through **financial intermediaries**, rather than through financial markets, making **indirect finance** more important than direct finance.

Naturally, both forms of financing **coexist** simultaneously in developed economies, and what differs across countries is their relative importance.

1.1. Definition and specificity of banking intermediation

How would you classify the financial system of the European Union (EU) and the United States (US)?

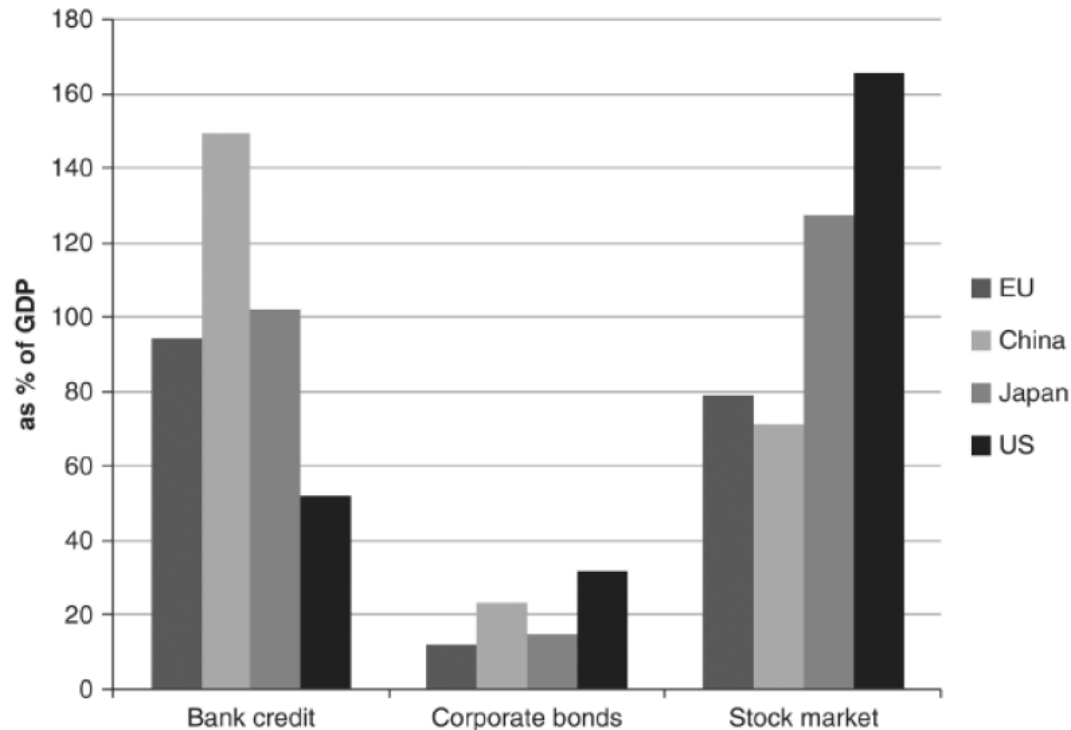


Figure 2. Relative importance of different funding channels. **Source:** De Haan et al. (2020).

1.1. Definition and specificity of banking intermediation

► Financial intermediation activity

Financial intermediation connects economic agents who **save**, with **excess resources** (the **savers**), to the economic agents who **need** these funds to invest (the **borrowers**).

► Broad definition of financial intermediaries

A **financial intermediary** is an economic agent specialized in the simultaneous buying and selling of financial contracts and securities (financial assets).

- Financial intermediaries include **banks, insurance companies, pension funds, money market funds, investment companies, venture capital and private equity firms, etc.**

- In general, the **existence** of intermediaries is **justified** by **imperfections and frictions in transaction technologies** (e.g., **transportation costs**). This rationale also applies to financial intermediaries, whose role is largely justified by their ability to reduce **transaction costs** and overcome information problems (**information asymmetries**).

1.1. Definition and specificity of banking intermediation

❑ Main Functions of the Financial System:

Mobilization of savings: the financial system collects savings from savers and allocates them to borrowers;

Diversification and risk sharing: investments are subject to idiosyncratic productivity and demand risks (banks can properly diversify their credit portfolio);

Providing liquidity: investments have a long maturity, but savers prefer short-term investments (banks finance long-term loans with liquid and short-term deposits);

Acquiring and providing information on investments: for a saver these costs would be very high (banks reduce transaction costs);

Supervising investments: savers typically lack the capacity to oversee investments effectively (banks reduce transaction costs);

Facilitating transactions: making means of payment available.

1.1. Definition and specificity of banking intermediation

Thus, by promoting the flow of funds from savers to economic agents in need of finance, financial intermediaries - particularly banks - contribute, among other things, to:

- ▶ **A more efficient allocation of the economy's resources**, as they are better equipped to identify productive opportunities for fund allocation.
- ▶ **Higher economic growth**, as funds are directed toward their most productive uses.
- ▶ **A better distribution of consumption over time**. As you may recall from your macroeconomics courses, economic agents seek to smooth their consumption. Banks not only collect households' savings but also allow them to borrow funds, enabling households to maintain consumption levels even during downturns. This is one example of how banks can directly **improve welfare** of economic agents.

1.1. Definition and specificity of banking intermediation

- ▶ However, sometimes things go wrong... This is precisely why we must study **the specifics of banking activity**, particularly how to manage the risks it entails.
- ▶ RTP, 13/03/2023 - **Largest bank failure since 2008. U.S. bank Silicon Valley Bank was shut down** - U.S. authorities announced this Friday the closure of Silicon Valley Bank, the main bank for U.S. tech startups. (...) According to U.S. media, SVB became insolvent after experiencing a run on its deposits, which it was unable to meet. (...)
- ▶ ECO SAPO, 20/03/2023 - **Signature Bank was the second bank to fail in the current banking crisis**, about 48 hours after the collapse of Silicon Valley Bank - Signature, headquartered in New York, had become involved in recent years in the cryptocurrency sector, treating it as a business with growth potential. The FDIC estimates that **Signature Bank will have cost the deposit insurance fund USD 2.5 billion (EUR 2.3 billion)**, a figure that may change as the regulator sells the assets. (...)
- ▶ Jornal de Negócios, 01/05/2023- Thus, the Federal Deposit Insurance Corporation (FDIC) – the agency responsible for guaranteeing bank deposits in the United States – **decided to shut down First Republic** due to its inability to halt deposit outflows, the deterioration of its assets, and the pressure it was putting on the stock market. (...)

Secondary Bibliography

- ▶ De Haan, J., Schoenmaker, D., & Wierds, P. (2020). *Financial markets and institutions: A European perspective*. Cambridge University Press.
- ▶ ECO (2023, March 20). *New York Community Bank compra parte do Signature Bank em negócio de 2,5 mil milhões*. Available at: <https://eco.sapo.pt/2023/03/20/new-york-community-bank-compra-parte-do-signature-bank-em-negocio-de-25-mil-milhoes/>
- ▶ Jornal de Negócios (2023, May 1). *First Republic Bank nas mãos das autoridades dos EUA e vendido ao JPMorgan*. Available at: <https://www.jornaldenegocios.pt/empresas/banca---financas/detalhe/first-republic-bank-nas-maos-das-autoridades-dos-eua-e-vendido-ao-jpmorgan>
- ▶ Mishkin, F. S. (2006). *The Economics of Money, Banking, and Financial Markets*. Pearson Education.
- ▶ RTP (2023, March 13). *Maior falência desde 2008: Banco norte-americano Silicon Valley Bank foi encerrado*. Available at: https://www.rtp.pt/noticias/economia/maior-falencia-desde-2008-banco-norte-americano-silicon-valley-bank-foi-encerrado_n1472708